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C O R R E C T E D C O P Y (TEXT)

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SUBJECT: ARGENTINE ECONOMISTS PREDICT GLOBAL ECONOMIC
TURMOIL WILL IMPACT ARGENTINA VIA COMMODITY PRICES

Classified By: Ambassador E.A. Wayne for Reasons 1.4 (b,d)

Summary

11. (C) Three prominent Argentine economists told visiting WHA DAS Chris McMullen October 2 that the global financial crisis will have a bigger impact on Argentina's real economy than its financial sector, due to the country's relative isolation from international capital markets. They noted that falling commodity prices and the sharp depreciation of the currency of Brazil, Argentina's largest trading partner, will lead to further deceleration of the local economy, raise fiscal pressures, and possibly increase tensions within the Mercosur trade bloc. Despite coming from different political perspectives, they agreed there is little chance of the opposition regaining control of the country anytime soon, and predicted that the ruling party will win the 2011 elections: "a Kirchner if the local situation has improved, otherwise some other Peronist, but not the opposition." End Summary.

Discussion of Current Challenges, With Focus on Politics

12. (SBU) Visiting WHA Deputy Assistant Secretary Chris McMullen and Ambassador Wayne met October 2 with three prominent Argentine economists representing different political views. Eduardo Curia, President of the Center of Social and Economic Analysis, has been one of the most vocal private sector supporters of ex-President Nestor Kirchner's economic policies, although even he began raising concerns about high inflation in early 2008. He commented that he still supported the model of maintaining an undervalued currency to support local industry, stating that he "is only happy when the U.S. dollar is expensive." Daniel Marx, head of AGM Consulting, served as Finance Secretary under ex-President Fernando de la Rúa, including during the 2001-02 economic crisis and default. Nevertheless, he is widely admired as professional and non-partisan, and is frequently consulted by senior GoA officials. The most junior of the three was Gabriel Sanchez, President of IERAL, the think-tank of Fundacion Mediterranea, which has been highly critical of the Kirchner economic model and is linked to the controversial economist Domingo Cavallo (Economy Minister under both Presidents Menem and de la Rúa). Nevertheless, Sanchez is also widely admired as a talented and moderate economist.

13. (C) The purpose of the meeting was to provide DAS McMullen with an informal briefing on the state of the Argentine economy. Therefore, the three focused on responding to the Ambassador's request for comments on the impact of four recent market-changing events: the financial crisis, rapidly falling commodity prices, and the GoA's two recent announcements that it would pay Paris Club creditors and was

considering a new debt exchange with holdout bondholders. All three analysts also offered comments on the political staying power of the Kirchners.

Real Economy in for Trouble; Financial Sector Cut Off

¶4. (C) Daniel Marx argued that ongoing international financial turmoil will have a much larger impact on the real economy than on the financial sector. Sanchez and Curia both agreed, pointing out that Argentina is cut off from international capital markets, but depends heavily on commodity exports. They also noted that the Argentine financial sector is small and isolated (and also relatively liquid), so is unlikely to be too affected by external events and also unlikely to transmit financial instability to the non-financial sector.

¶5. (C) Marx argued that the two main reasons for recent spikes in commodity prices have been high demand and easy access to credit, which spurred speculation. Both of these forces have diminished significantly, he pointed out, which will reverberate through the Argentine economy. He noted that Argentina was well placed to benefit from the run-up in prices because it has been in the vanguard of technological change in the agricultural sector. This allowed the country to increase the production of soy, corn, and wheat by 70% in the last 10 years, with only a 20% increase in land area harvested. Now, with world demand slowing and with an anticipated increase in competition from Brazil -- due to the rapidly depreciating Real and slightly stronger Argentine peso -- Marx predicted that Argentina will have a tougher year in 2009 than it has seen since the 2001-02 crisis. Even so, he expects the economy to hold up better than it has during the other economic downturns of the last 10-20 years.

¶6. (C) Sanchez added that external problems would exacerbate fiscal pressures for the Kirchner government. He said the economy was already decelerating due to internal factors, particularly high inflation, and that this would result in lower tax revenues. He commented that the Kirchners have always had two options: implement a credible anti-inflation plan, bringing down growth to a sustainable level, or allow it to happen on its own in an uncontrolled manner. By rejecting the first option and instead continuing procyclical fiscal and monetary policies in an attempt to keep the post-2002 crisis boom going, the Kirchners now face the prospect of having to cut spending, cut subsidies, and increase prices for public services just as the economy is decelerating rapidly. Given the GoA's greater dependence on revenues from taxes on exports, Sanchez thought global uncertainty and falling commodity prices would just exacerbate these domestic trends.

¶7. (C) Marx agreed with Sanchez' analysis, adding that GoA officials were sending mixed signals regarding economic policies. In his opinion, there was a debate going on between those who believe "the party can continue" and those within the GoA that are extremely concerned about economic problems in 2009. He thought one area in which this disagreement would play out was over the exchange rate. The President recently surprised private analysts by publicly telling the heads of industry that the GoA could not currently support the rapid depreciation of the peso -- using a rather orthodox line of reasoning that a depreciated peso would only lead to higher inflation. However, Marx worried that, as export tax revenues fall, there will likely be increasing support within the GoA to depreciate the peso in order to make up the shortfall on higher export volumes.

¶8. (C) Both Marx and Sanchez thought that paying Paris Club and re-opening the debt exchange to holdout bondholders could help mitigate the impact of slowing growth and falling commodity prices, as they have the potential to help Argentina re-integrate into global capital markets. They should also lead to lower interest rates on Argentine debt. Marx argued that Argentina has been excessively punished in the capital markets, with yields on Argentine 10-year bonds currently in the 19-21% range. If the Paris Club and debt

swap initiatives are successful, he said, this should open access to substantially cheaper credit, which would in turn make longer term credit available, spur more private sector borrowing, expand production, and enhance Argentine industry's ability to compete against Brazilian and other major trading partner manufacturers.

Possible Fallout in Mercosur

¶9. (C) All three economists predicted that another possible result of world events was heightened tension among Mercosur members. Sanchez commented that Brazil and Argentina had chosen different paths in recent years, with Brazil pursuing an expansionist outlook, negotiating international trade agreements and being active in Doha talks. Meanwhile, Argentina had become increasingly inward-focused, taxing exports and trying to increase protection for local industry. The result, he said, was that Brazil was gaining world market share, while Argentina had diminished as a percentage of total world trade. Therefore, he thought, the recently depreciated Brazilian Real could cause bilateral conflict to increase between the two.

¶10. (C) While not disagreeing, Marx commented that in the 1990s Argentina had a trade surplus with Brazil despite the artificially strong peso. Now with a much weaker peso, Argentina has a large trade deficit with Brazil. He concluded that Argentina tends to import more from Brazil when the peso is weaker, and that the result of a relatively stronger peso (against the Real) may just result in a substitution of Brazilian imports with those from other countries.

Disagreement over GoA Protection of Industry

¶11. (C) The only area of mild disagreement among the three surfaced following DAS McMullen's comment that it appeared that Argentina might be over-taxing its most productive sector, agriculture, in order to support less competitive industry. McMullen asked whether this might reduce popular support for the Kirchners. Curia argued that only 25-30% of the population was associated with the agricultural sector or areas of the economy benefiting from agriculture. Therefore, he argued, supporting industry was more important, from a political perspective. "If you do not have a sustainable

TURMOIL WILL IMPACT ARGENTINA VIA COMMODITY PRICES

industrial development plan," he said, "you will have high unemployment and social tension." He added that unemployment was terrible during the 1990s, when Argentina had pursued "its own particular version of the Washington consensus," and this led to the self-destruction of the Menem/Peronist government and the presidential win in 1998 of opposition politician Fernando de la Rúa. This is why the Kirchners still see urban industrial workers as their critical pillar of political support, he concluded.

¶12. (C) Marx clarified that Argentina's industrial base is evolving and is increasingly outside of cities and connected to the agricultural sector. Sanchez added that only 20% of the workforce is tied to industry, and that service sector labor makes up the largest percentage of total employment. He disagreed with Curia's assessment, arguing that sustaining the Kirchners' metropolitan area, lower income political base requires more work on reducing poverty levels rather than increasing (already historically high) employment levels. Therefore, he stated, the Kirchners' social spending programs and price controls (especially for utilities) have been the key elements in maintaining popular support.

Argentine Politics: Peronists Here to Stay

¶13. (C) Interestingly, all three independently offered views on the political staying power of the Kirchners, coinciding in the opinion that the opposition is fractured and will not regain power anytime soon. Curia noted that the GoA is weak under President Cristina Fernandez de Kirchner, compared to the greater power her husband Nestor Kirchner wielded as

President. However, he pointed out that the opposition was only able to find common cause during the March-July agricultural strike because it went on so long and was so damaging. That has not proven sufficient to solidify the opposition going forward. The Kirchners know the opposition will gain positions in Congress during the mid-term elections in 2009, he said, but all three agreed that such gains will not be sufficient to establish an opposition majority. Sanchez added that the opposition only seems capable of seizing power in Argentina when commodity prices are low, and he thought that was not by accident: the only moments they can muster the votes is when the economy is in shambles and the Peronists are in disarray. Therefore, despite the current administration's weakened status, all three were in agreement that a Peronist is likely to win the next presidential elections in 2011. Whether the next victor proves to be one of the Kirchners or some other as-yet-unidentified Peronist party leader, they said, will depend on the state of the economy.

WAYNE